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¶1. SUMMARY: Plans to inject capital into Landesbank Baden-Wuerttemberg (LBBW) and merge it with Bavarian counterpart BayernLB have hit a roadblock as one owner, the city of Stuttgart, has said it will not support risking taxpayer money to fund a bank that is losing money. Stuttgart has split with LBBW's other two owners, the state government and the association of savings banks, who are in favor of helping LBBW. The city's reluctance to chase bad money with good is a rare example to date of elected officials questioning the wisdom of using state funds to help banks. END SUMMARY.

Stuttgart Balks at Capital Injection and Merger

¶2. After announcing a 5 billion euro ($6.45 billion) capital injection for LBBW in November, the bank's three owners, the state of Baden-Wuerttemberg (B-W), the B-W savings banks and the City of Stuttgart have yet to deliver on the announced funds. The capital injection would boost LBBW's capital ratio up from a dangerously low 6.8% and allow it to go forward with a merger with BayernLB. Stuttgart Lord Mayor Wolfgang Schuster (CDU) faces a hostile city council, which opposes the city's 950 million euro ($1.2 billion) share of the package. SPD city council member Andreas Reissig told Econ Spec that his party will recommend the city sell its 18.9% share to the state government, rather than give any taxpayer money to LBBW.

¶3. Meanwhile, B-W Minister-President Guenther Oettinger (CDU) and his Bavarian counterpart Horst Seehofer (CSU) have met several times since the beginning of the year to discuss a possible merger of LBBW with BayernLB. Lord Mayor Schuster was apparently shocked to learn of the "secret" meetings, insinuating that Oettinger was acting in a high-handed way and taking the city's support for granted. Schuster has since come out saying both banks need to get their houses in order or else he will veto a merger. Schuster argued that LBBW is already sufficiently burdened with bad assets from its takeovers of Sachsen LB and Landesbank Rheinland-Pfalz.

¶4. Financial conditions have also worsened in recent months and LBBW officials have said that even the 5 billion euro injections may not be enough. Year-end reports are still pending, fueling speculation that LBBW's losses will exceed previously announced 2 billion euros ($2.6 billion). (Note: State banks are only required to report on an annual basis but generally provide voluntary quarterly reports.) Meanwhile, BayernLB losses are a catastrophic 5 billion euros ($6.45 billion), up from an earlier expected loss of 3 billion euros ($3.87 billion), leading many to question the wisdom of the merger.

State Government in Favor but Faces Difficulties

¶5. Minister President Oettinger faces difficulties with the merger. The CDU-FDP majority state parliament must pass a budget by the end of February, before year-end reporting from LBBW in March reveals how deep losses at the bank go and how much capital will be required. Opposition SPD caucus chief Claus Schmiedel has also spoken out against the bank merger, saying it makes little sense for two banks that are losing money to merge. Opposition politicians also criticize LBBW for concealing the true extent of its losses.

¶6. Oettinger, however, remains strongly in favor of moving forward. Reissig argued that Oettinger's main motivations were political: he wanted to mitigate federal interference by keeping LBBW out of the federal rescue package while at the same time expanding the bank's operations, and thereby the state's influence as owner, into Bavaria. The B-W savings banks also stand to benefit from the deal as they would gain access to new business in Bavaria. Oettinger has recently suggested that LBBW and BayernLB pool their non-performing assets into a separate "bad bank" to allow the merger to go forward.

¶7. COMMENT: While B-W state officials see an opportunity in the crisis to expand their own reach through a merger, the city of Stuttgart has questioned how wise it is to fund banks whose outlook is only worsening. At the federal level, there has been little debate about whether taxpayer money should be used to fund troubled banks such as Hypo Real Estate and Commerzbank, as politicians have been primarily concerned with stabilizing the financial sector, rather than making sound investments. The mood in Stuttgart has, however, changed, with city officials and opposition parties balking at what may be a bad deal for the taxpayer. END COMMENT.

¶8. This cable was coordinated with Embassy Berlin and ConGen Munich.
POWELL